

POSTED
7/9/01

BEFORE THE
PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

Docket No. 2000-0207-W/S

SURREBUTTAL TESTIMONY

OF

JOHN B. LEGLER

ON BEHALF OF

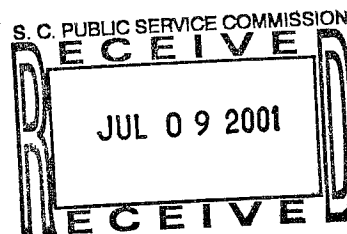
THE DEPARTMENT OF CONSUMER AFFAIRS

CONCERNING

FAIR RATE OF RETURN

JULY 9, 2001

RETURN DATE: 07/09/01
SERVICE: OK



1 Q. PLEASE STATE YOUR NAME AND ADDRESS.

2 A. John B. Legler, 1040 St. Andrews Court, Bogart, Georgia 30622.

3

4 Q. ARE YOU THE SAME JOHN B. LEGLER WHO PREVIOUSLY FILED DIRECT
5 TESTIMONY IN THIS CASE?

6 A. Yes.

7

8 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

9 A. The purpose of this testimony is to rebut certain aspects of the rebuttal testimony
10 of Company witness Pauline M. Ahern and to clarify some aspects of my direct
11 testimony which may have caused some confusion.

12

13 Q. AT PAGES 20-21 OF HER REBUTTAL TESTIMONY MS. AHERN STATES THAT
14 "ALTHOUGH DR. LEGLER ACKNOWLEDGES THAT SIZE CAN AFFECT THE
15 BUSINESS RISK OF A UTILITY ON PAGE 19, LINES 19 AND 20 OF HIS DIRECT
16 TESTIMONY, HE HAS CONCLUDED THAT HE HAS 'NO REASON TO BELIEVE
17 THAT THE GROUP, ON AVERAGE, DOES NOT APPROXIMATE THE RISKINESS
18 OF CAROLINA WATER'." PLEASE COMMENT.

19

20 A. My comment was with respect to the size and economic base of the area served by
21 the utility, not the size of the utility. Ms. Ahern goes on to say that "Erroneously,
22 therefore, Dr. Legler made no adjustment to the results of his cost of equity analysis

1 for the water utilities to reflect Carolina's increased risk due to its very small size.
2 For this reason, based on the table above, I conclude that Dr. Legler's
3 recommended common equity cost rate range of 10.0% - 11.0% is grossly
4 underestimated." If this is, as she states, her reason for concluding that my
5 estimated range is grossly underestimated, then her conclusion is incorrect.
6

7 **Q. ON PAGE 17 OF HER REBUTTAL TESTIMONY, MS. AHERN HAS A TABLE OF**
8 **PROPERLY CALCULATED COMMON EQUITY COST RATES. DO YOU AGREE**
9 **WITH HER THAT THESE ARE PROPERLY CALCULATED COMMON EQUITY**
10 **COST RATES?**

11 A. No, I do not. These are cost rates based on Ms. Ahern's interpretation of the data,
12 and while I cannot speak for Dr. Spearman, I do not agree with her manipulation of
13 my numbers. I do note that the last line of this table of numbers is titled "Range of
14 Properly Calculated Common Equity Cost Rates." For the entries attributed to
15 myself, she has a range of 10.00% - 11.00%. As she notes, this range is without
16 regard to an adjustment for Carolina's small size. Of course I agree that this is a
17 range of properly calculated cost rates.
18

19 **Q. MS. AHERN IS CRITICAL OF YOUR RISK PREMIUM ANALYSIS. DO YOU HAVE**
20 **ANY COMMENTS IN RESPONSE?**

21 A. I acknowledged in my direct testimony that my risk premium study was prepared for
22 another case, and I did not have time to prepare a new study for this case. I noted,

1 as she cites my testimony, that three of the companies included in my sample have
2 been acquired and no longer have stock that is publicly traded. The three
3 remaining companies are three of the four companies in Value Line's current water
4 industry. I do note that she failed to mention the fact that my CAPM analysis also
5 was based, in part, on companies taken from Value Line's expanded edition.
6 Although my risk premiums are from a different time frame, I did use a current bond
7 yield in making my risk premium estimates of the cost of equity. In contrast to my
8 equity risk premiums which are specific to the water industry, Ms. Ahern began her
9 risk premium analysis with arithmetic mean return on the S&P 500 index. While she
10 says that my risk premium study is inconsistent with a DCF-based common equity
11 rate for the four Value Line water companies, her two water groups (the C.A. Turner
12 group of eight companies shown on Schedule 12 of her Direct Testimony and the
13 four Value Line companies) are really the same sample, since the C.A. Turner
14 companies do not have betas beyond those reported for the Value Line companies.
15 She also states that my DCF-based risk premiums are understated because the
16 DCF model understates the equity returns when the market-to-book ratio is above
17 one. While the market-to-book ratios of utilities are currently above book value,
18 they haven't been for the entire time period. In short, according to her logic, if my
19 risk premiums in recent years are understated, they must be overstated in those
20 years when the market-to-book ratios were less than 1.0.
21 On page 11 of her rebuttal testimony, there is an obvious error. She states that had
22 I used more appropriate (in her opinion) risk premiums of 5.1% and 5.2%, and a

1 Moody's single-A bond yield of 8.2%, my estimated range would have been 12.9%
2 to 13.5%. The same bond yield with risk premiums which differ by only 10 basis
3 points should produce estimated returns which differ by 10 basis points, not the 60
4 basis point spread she states. The correct returns based on her assumptions and
5 a bond yield of 7.8% would be 12.9% to 13.0% which she shows on lines 18 and
6 19 of page 11 of her rebuttal testimony.

7
8 **Q. DO YOU HAVE ANY RESPONSE TO MS. AHERN'S COMMENTS ABOUT YOUR**
9 **CRITICISM OF THE USE OF ADJUSTED BETAS?**

10 A. Yes, I do. A cursory examination of betas of utility companies produced by Value
11 Line does not suggest that the betas of utility companies converge towards 1.0. If
12 Ms. Ahern's comment is intended to imply that I used only unadjusted betas, she
13 is simply wrong. I used both unadjusted and adjusted betas in my analysis. We
14 both use Value Line betas which by their nature are historical betas. Thus, the
15 betas could be called "prior" estimates, and we are seeking expected betas. As
16 Morin states, "But a sensible 'posterior' estimate would likely lie between the two
17 values." [See Schedule 5 of Exhibit No. ____ (PMA-2)].

18 I would take this to mean that the true beta for our purposes lies somewhere
19 between the unadjusted and adjusted betas. Therefore, all of our CAPM estimates
20 of the cost of equity are wrong, but the correct estimate is somewhere between the
21 estimates based on the unadjusted and adjusted betas.

1 **Q. DO YOU HAVE ANY ADDITIONAL COMMENTS?**

2 A. Yes. Ms. Ahern complains that I failed to consider Carolina's small size relative to
3 my groups of proxy companies. What she apparently fails to see is that a fair
4 comparison would not be between Carolina Water Service and the Value Line
5 companies, but between Utilities, Inc. and the Value Line companies. Thus, her
6 proposed adjustment is irrelevant.

7

8 **Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?**

9 A. Yes, it does.